THE STATUS OF STOCKHOLDERS RELATIVE TO THE INTERNAL AFFAIRS OF CORPORATIONS.

THE above styled subject must be treated under three heads: (1) The relationship between the stockholders and the officers or directors; (2) The relationship of the stockholders between themselves; and (3) The relationship between the majority and the minority stockholders. There is, of course, no distinction between the duty which the officers and directors owe to minority stockholders and that which they owe to the majority stockholders, since their interests are identical in substance and differ only in amount. Nor does the amount of stock held affect the mutual obligations of the stockholders acting among themselves for the accomplishment of a joint purpose and advantage. The practical effect of the power of the majority stockholders, which vests in them the control of the corporation, imposes upon them, in the exercise of this power, certain obligations to the corporation, and to the minority stockholders as beneficial part owners of the corporation.

THE RELATIONSHIP BETWEEN THE STOCKHOLDERS AND THE OFFICERS OR DIRECTORS.

At law, the officers and directors are regarded, strictly speaking, as agents of the corporation. However, in equity they are regarded as also trustees for the corporation and its stockholders. As agents of the corporation, the directors are forbidden to exercise their powers for their own personal ends against the interests of the corporation, and are precluded from deriving any advantage from contracts made by their authority as directors, except through the corporation for which they act. Officers and directors will not be permitted to occupy positions which will conflict with the interests of the corporation which they serve, and they cannot, while acting in their capacity as agents and trustees of the corporation, properly authorize contracts on behalf of the corporation for which they act and then

personally participate, directly or indirectly, in the benefits therefrom.[1] The same principle applies as between promoters or organizers of a corporation and the subscribers to stock.[2] Neither can a commercial traveler, without the knowledge of his employer carry a competing line of goods. In a recent case,[3] the Court held as follows:

> "The attempts on the part of agents and others engaged in a fiduciary capacity to obtain undue advantage from the relationship has taken many forms, and are restricted in number only by the limitations of human ingenuity, but the law has never failed in its insistence that an unfaithful agent may not retain and enjoy the fruits of his unfaithfulness."

It has been held[4] that where an officer, or director of a corporation deals with himself as an individual, or as an officer or director of another corporation, with respect to matters of the corporation, that "the transaction is at least open to question by the corporation, in a proper case, by its stockholders," and that the officer will be required to explain and show that no undue advantage has been taken of the stockholders. Should the officer or director, while acting on behalf of the corporation, reserve or secure for himself any covert consideration, it will be held to belong to the corporation.[5]

An officer or director cannot, by failure to disclose any information which he has obtained while an officer or director and which in a sense of fairness he should report, buy up the stock of the corporation and make a profit for himself thereby. To acquire for himself or for any one else the corporate property or its capital stock without a full disclosure to the stockholders of all material information and knowledge acquired as to its condition and value has been held to constitute a fraud.[6] In the case of Commonwealth Title Co. *v.* Seltzer,[7] a party de-

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[1] Wardell *v.* Union Pac. R. Co., 103 U. S. 651 (1880).

[2] Brewster *v.* Hatch, 122 N. Y. 349, 25 N. E. 505 (1890).

[3] Reis *v.* Volck, 151 App. Div. 613, 136 N. Y. Supp. 367 (1912).

[4] Sage *v.* Culver, 147 N. Y. 241, 41 N. E. 513 (1895).

[5] Koster *v.* Pain, 41 App. Div. 443, 58 N. Y. Supp. 865 (1899).

[6] Black *v.* Simpson, 94 S. C. 312, 77 S. E. 1023 (1913); Commonwealth, etc., Co. *v.* Seltzer, 227 Pa. 410, 76 Atl. 77 (1910).

[7] *Supra.*

siring to purchase certain property belonging to a corporation opened negotiations with its president. The latter declined to sell the property but went about among the stockholders and bought up sufficient stock to give him control over the majority of the stock. He then sold his stock to the prospective purchaser at an enhanced price. The purchaser of the stock thereupon caused the corporation's property to be conveyed to his nominee at a price which was fair and adequate. The stockholders, however, brought suit against the president, claiming that the profit which he made by the sale of his stock was virtually a profit realized upon the sale of the corporate assets. The Court so held, and decreed that not only the president but an associate, whom he had brought in with him on the deal to furnish a part of the capital, must account to the corporation for their profit. In confirming the decree of the trial court, the appellate court said:

> "The purchaser wanted the property and was willing to pay a price for it. The defendants knew this, and the facts justify the inference that the stock dealing was for the purpose of diverting a part of that price from the corporation into their own pockets; and this, in a nutshell, is the theory upon which the case was decided."

It has been held that where an officer of a corporation had received an offer for the entire capital stock and, without making any disclosure of this fact, bought up the stock of a stockholder, the plaintiff in the suit, at a smaller figure than the plaintiff's *pro rata* share of the entire price, the officer could be compelled to account to the plaintiff for the difference.[8]

However, it does not follow from the principles laid down and the cases cited that a managing officer or director of a corporation can never enter into a contract while acting for the corporation from which he will derive individual consideration, simply because his contract is incident to the corporation's contract. In the case of Bristol *v.* Scranton,[9] the president and vice-president of a corporation were authorized to represent the corporation and conduct the negotiations incident to merging it with

[8] Barber *v.* Martin, 67 Neb. 445, 93 N. W. 722 (1903).

[9] (C. C. A.), 63 Fed. 218 (1894).

another corporation. These officers efficiently, diligently and honestly represented the corporation, and their actions were specifically authorized and approved. The officers of the merging corporation deemed it highly to the advantage of their corporation that these two officers of the merged corporation should never engage in any competitive business in that or any nearby state and, in consideration of such individual agreement on their part, paid them a large sum of money. Some of the stockholders of the merged corporation, on behalf of themselves and other stockholders, sued these officers, claiming that the money received by them constituted a part of the entire consideration for transfer of the property and assets of the merged corporation, and that it was, therefore, the duty of these officers to account for this money to the merged corporation. The court said:

> "The contract of consolidation was conceived in integrity of purpose, was born in good faith, and was indelibly marked with the impress of honor and fair dealing."

The court, however, absolutely upholds the doctrines hereinbefore set out which forbid an agent from entering into a contract which conflicts or which may conflict with the interest that he represents. But in the case just explained the court held that the individual contract was not based upon the consolidation and did not spring from it, nor was the sum paid to the officers a payment or reward for successfully effecting the consolidation, but, on the other hand, it was clearly a "condition precedent to any consolidation at all," the consolidation being beyond question advantageous in every detail. Had these officers "refused to sell their time, their experience, their knowledge, their ability, the stockholders of the Scranton Company [the merged corporation] never would have had the opportunity to wire congratulations" to these officers for the "triumph" which they had won. The court further said:

> "In no proper sense were the bonds [the sum paid the officers] in controversy a profit made out of the agency or fiduciary relationship which existed. They were not a gratuity, nor were they paid to the Scrantons because of their fiduciary position. * * * The two contracts were distinct in parties, subject matter, and consideration."

THE RELATIONSHIP OF STOCKHOLDERS AS BETWEEN THEMSELVES.

Where all of the stockholders are acting jointly in an endeavor to get the best possible price for the corporate property or its capital stock, it is the duty of each stockholder to give his fellow stockholder the benefit of his service and knowledge and to account for any excess over the full price at which the sale was made.[10] A mill owner entered into a contract whereby he was to obtain a remuneration for effecting the consolidation of a large number of mills, including his own. Concealing the fact of this individual interest, he went among his fellow mill owners and used his influence to bring about the consolidation, leading them to infer that his interest was the same as theirs. A suit was brought by these mill owners, and it was held that while this was no defense to the right of the promoting mill owner to recover his remuneration contracted for from the corporation, yet that he would be required to account for this remuneration to and share it with his fellow mill owners, who had not been informed of the facts.[11]

A very interesting discussion of wrongful acts of a stockholder in making a covert agreement for the sale of his stock, different from the terms of the sale of other stock, is found in the case of Synnott *v.* Cummings.[12] In this case there were three parties who owned three-eighths, three-eights and two-eighths, respectively, of the capital stock of the Atlantic Match Company. They were approached by the National Match Company who offered to purchase the entire property assets of the Atlantic Company for a large sum in stock of the Atlantic Company. Unknown to the other two, one of the stockholders who owned three-eighths of the stock received an additional consideration. The court very succinctly states the proposition as follows:

"Can two parties who are jointly interested in a corporation or association, or any other matter, although they have

[10] Milton *v.* Sachs, 91 Iowa 386, 391.

[11] Boice *v.* Jones, 106 App. Div. 547, 94 N. Y. Supp. 896 (1905).

[12] (C. C.), 116 Fed. 40 (1902).

separate interests, jointly bargain for the disposition of the whole subject, and then one or the other make a contract and different agreement, for his own benefit, and reciprocally to the disadvantage of his co-owners? It seems to me that in a court of conscience there could be but one answer to anything of that kind,—that, equitably, a person who undertook to make a bargain of that character would have to account to his fellows for the result; and I can see no escape from that responsibility here."

The court further adds:

"If it were clear that these $200,000.00 [the additional consideration] were given to Cummings as a distant and separate sum for something that he himself individually and personally contributed, and which was demanded of him that he should do, or give, or contribute, we should have something which could be supported in his favor. I refer to that in order that I may put on record that the case in this circuit of Bristol *v.* Scranton, 57 Fed. 70, and again on appeal, 4 C. C. A. 144, 63 Fed. 218, is clearly in my mind."

There would seem to be no reason why the same doctrine should not apply in corporations with numerous stockholders, when the stockholders are apparently co-operating to accomplish some joint advantage or benefit for the corporation. Of course, one stockholder may do what he wishes with his own stock while acting purely individually, provided that he does not mislead his fellow stockholders or take an unfair advantage of the control over the corporation which his amount of stock may give him.

THE RELATIONSHIP BETWEEN THE MAJORITY AND MINORITY STOCKHOLDERS.

In the very nature of things, the power of the majority exceeds that of the minority. This is as true in the case of the sovereign states and municipal corporations as in the case of private corporations. For protection against certain acts of the majority, the minority may look to the constitution or charter of the corporation. Just as a certain majority may change the constitution of a sovereign state or the charter of a municipal

corporation, so a certain majority may change the charter of a private corporation. In effecting such changes statutory regulations and principles of law must, of course, be regarded. In the case of private corporations, the minority stockholder, in order to obtain relief, must show that the directors have been appealed to and are at fault and that a majority of the stockholders have been likewise appealed to without result before he can maintain his suit; unless it be shown that there was no opportunity for such application, or that such application would be futile (as where the alleged wrongdoers control the corporation), or that the delay caused thereby would defeat the objects of the suit. There is also the equally well settled rule that courts seldom interfere with directors in order to control any question of internal business management of corporations, except where the directors are guilty of misconduct amounting to a breach of trust or where the directors stand in a dual relation which prevents them from exercising an unprejudiced judgment.[13]

The minority stockholders' suit is based upon the theory of a wrong done to the corporation and must be brought on behalf of the stockholders and in a court of equity, inasmuch as it is in the nature of a suit for an accounting and for the prevention of illegal acts. The corporation and the parties alleged to be guilty of the wrongful acts, and any other parties who might be affected, should be made parties defendant.[14] A receiver is often appointed; but this is not indispensable, and it will not be done if the court can properly and conveniently adjust the rights of the parties with less delay and expense.[15]

Assuming that the minority stockholder has brought himself within the jurisdiction of a court of equity—that is assuming: first, that the acts complained of are such as amount to a breach of trust and such as neither a majority of the directors nor of the stockholders can ratify or condone; second, that the

[13] Ward *v.* Hotel Randolph Co., 65 W. Va. 721, 63 S. E. 613 (1909); Smiley *v.* New River Co., 72 W. Va. 221, 77 S. E. 976 (1913); Hawes *v.* Oakland, 104 U. S. 450 (1881); United States Copper Sec. Co. *v.* Amalgamated Copper Co., U. S. Adv. Aps., 1917, p. 509.

[14] 3 Cook, Corps.. 6 ed., § 734, 738.

[15] Commonwealth, etc., Co. *v.* Seltzer, *supra.*

complaining stockholder himself is free from laches or acquiescence, or ratification of the acts to remedy which the suit is brought; third, that the directors and stockholders have been requested and have neglected or refused to institute the suit, or that such would be futile; fourth, that the suit is instituted by a bona fide stockholder as a complainant, and that the corporation, the guilty parties and all other proper parties have been made defendants; what, then, are the principles by which the court will be governed?

The majority stockholders will not be permitted, by use of their power due to their holdings in the corporation, to take any unfair advantage of the minority stockholders, or to make any individual profit for themselves through their "control" of the corporation. For example, the holders of a majority of the stock of a corporation cannot force a sale of all the corporate property to themselves, or to another corporation in which they are interested for its value, when they know that a better price can be obtained—even though the sale be unassailable in equity and be made in strict accordance with the law. Such an act, though proper in every other sense, constitutes the violation of a fiduciary duty.

In the case of Wheeler *v.* Abilene Nat. Bank Bldg. Co.,[16] the court said:

> "A corporation holds its property in trust for its stockholders. The stockholders have a joint interest in the same property and in the same title. Community of interest in a common property or title imposes a community of duty and a mutual obligation to do nothing to impair either. It creates such a fiducial relation as makes it inequitable for any of those who thus share in the common property to do anything to or with it for their own profit, to the detriment of others who have the same rights.
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> "The holder of the majority of the stock of a corporation has the power, by the election of directors and by the vote of his stock, to do everything the corporation can do. His power to control and direct the action of the corporation places him in its shoes, and constitutes him the actual,

[16] (C. C. A.), 159 Fed. 391, quoted with approval in the recent case of McManus *v.* Durant, 168 App. Div. 643, 154 N. Y. Supp. 580 (1915).

> if not the technical, trustee for the holders of the minority of the stock. He draws to himself and uses all the powers of the corporation. In effect he holds an irrevocable power of attorney from the minority stockholders to manage and to sell the property of the corporation, for himself and for them. Time, places, and notices of meetings of the directors and of meetings of stockholders become of secondary importance, because the presence, the vote, and the protest of the holders of the minority of the stock are unavailing against the will of the holder of the majority. They [*i. e.*, the minority stockholders] can act and contract regarding the corporate property, they can preserve and protect their interest in it, only through him [*i. e.*, the majority stockholder] and through the courts."

The court goes into the matter fully and holds that this devolution of unlimited power imposes upon the majority stockholders a correlative duty—the duty of a fiduciary—to the minority stockholders, who can act only through them. Any act on the part of the majority stockholders by virtue of their control by which they obtain some peculiar or individual benefit, which is not shared in by the minority stockholders or which is to their detriment, becomes a breach of duty and trust, renders the transaction voidable, and gives the minority stockholders grounds for seeking plenary relief in a court of equity.

In the case of Rogers *v.* Nashville, etc., Ry. Co.,[17] Mr. Justice Lurton, speaking of the wrongful use of the power of majority stockholders, says:

> "But the majority will not be permitted to use this power of control for the purpose of obtaining advantages for themselves at the expense of the minority, and when, an unfair or oppressive contract is shown, a case is made which will authorize interference on behalf of the injured minority."

The case of Stebbins *v.* Michigan Wheelbarrow & Truck Co.,[18] approving the doctrine laid down in Rogers *v.* Nashville, holds that where the majority stockholders of a corporation vote for a transfer of all of its assets to another corporation, in which they become stockholders, then they have the burden of

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[17] (C. C. A.), 91 Fed. 299, 313 (1898).

[18] (C. C. A.), 212 Fed. 19 (1914).

proving, as against the dissent of the minority stockholders who receive no interest in the other corporation, that the amount received for the assets was its full value. The price being inadequate, the majority stockholders who obtained benefits from the transfer were required to pay to the minority stockholders their proportionate share of the benefits. The decision was based upon the principle hereinbefore stated: The majority stockholders occupy a fiduciary relation towards the minority stockholders in the exercise of their power over the corporation.

In the case of Ervin *v.* Oregon Ry. & Nav. Co.,[19] it was held that where a number of stockholders combine to constitute themselves a majority to control the corporation as they see fit they become for all practical purposes the corporation itself and assume a relation of trust to the corporation and to its stockholders, and if they seek to make a profit out of it at the expense of those whose rights are the same as their own they are unfaithful to the trust relation they have assumed, and are guilty of, at least, constructive fraud, for which a court of equity will give relief.

In the case of Meeker *v.* Winthrop Iron Co.,[20] it was held that a majority of the holders of the capital stock of a corporation could not, by their votes in stockholders' meetings, lawfully authorize its officers to lease its property to themselves, or to another corporation controlled by them, unless such lease was supported by an adequate consideration; and that in a suit to set aside such a lease, the burden of proof to show absolute fairness and adequacy is upon the majority stockholders.

These doctrines have been relied upon often by the courts, particularly in New York, where some years ago wrongful stock manipulation was not as uncommon as it is today. The matter is treated fully in Gamble *v.* Queens County Water Co.,[21] Pondir *v.* New York, etc., R. Co.,[22] Barr *v.* New York, etc., R. Co.,[23] Meyer *v.* Staten Island R. Co.,[24] and Farmers' L. & T.

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[19] (C. C.), 27 Fed. 625 (1886).
[20] (C. C.), 17 Fed. 48 (1883).
[21] 123 N. Y. 91, 25 N. E. 201 (1890).
[22] 72 Hun. 384, 25 N. Y. Supp. 560 (1893).
[23] 96 N. Y. 444 (1884).
[24] 7 N. Y. St. Rep. 245.

Co. *v.* New York & N. R. Co.[25] The last named case contains a particularly full and able opinion, and holds that one corporation cannot acquire the majority of the stock of another corporation and manage and manipulate it to its own advantage regardless of the rights of the minority stockholders.

It would seem to be well settled that the law requires of the majority stockholders the utmost good faith in the exercise of their control and in the general management of the corporation as regards the rights of the minority stockholders, and in this respect the majority stockholders stand in much the same attitude towards the minority stockholders that the directors sustain toward all of the stockholders. Majority stockholders, for example, in two corporations which have contractual relations cannot manage the affairs of one corporation for the benefit of the other to the disadvantage of the rights of the minority stockholders in the first corporation.[26]

In laying down the doctrines which determine the legal rights of the stockholder relative to the internal affairs of the corporation, the courts have not merely been engaged in deciding individual controversies, but have determined that the fundamental principles of right and justice should be the basis of these doctrines, which can be administered in full response to the spirit of progress and the needs of present business conditions.

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[25] 150 N. Y. 410, 44 N. E. 1043 (1896).

[26] Farmers' L. & T. Co. *v.* New York, etc., R. Co., 96 N. Y. 444; 1 MORAWETZ, PRIV. CORP., 2 ed. § 529; 1 BEACH, PRIV. CORP., § 70; 2 BIGELOW, FRAUD, § 645.